January 14, 2014

Enclosed is your statement for the fourth quarter of 2013.

The past quarter was exceptional. Equity markets soared with the S&P 500 up 10.5%, the Dow up 10.2% and the tech heavy NASD up 11.1%. While we don't tend to emphasize individual years, these quarterly returns capped an already ebullient 2013. The result was a year in which returns for both Academy Capital and the S&P 500 were the highest since our measurement began in 1999.

Because of the strength of the year's equity markets, 2013 was the first year in which the five year rolling average of the S&P 500 was higher than ours. For long time clients, this should come as no surprise as we tend to earn the biggest part of our paychecks in down markets. However, new clients unaccustomed to anything but rising markets may be concerned.

Because our portfolios are managed individually, if you have been an equity investor with us since at least 2009, you are nearly fully invested in companies with low cost bases. The Great Recession of 2009 provided great purchasing opportunities. However, if you joined us recently or added significant funds, you hold a portfolio which is heavily invested in cash, awaiting opportune investments which lately have occurred less frequently. The result is that as long as this market continues its upward ascent, the more likely it is that there will be a disparity of results between the S&P 500, long term clients and those joining us more recently.

Those of you newer to the firm would probably like to know whether we think the recent high valuations and soaring market have effectively shut you out. At the other end of the spectrum, those of you more fully invested are likely asking whether, given the recent soaring market, we should now start selling out. Both types of clients, in other words, fear there is a bubble unfolding in the equity markets.

These concerns are reflected in those of bond investors. If you were invested in high quality bonds, 2013 was not good to you. For the quarter, the 1-year Treasury Index had barely positive returns of 0.20%, while the 5-year Treasury Index lost 0.87% and the 10-year Treasury Index lost 2.45%. This was the fifth losing quarter in a row for the 10-year Treasury Index which has lost nearly 15% over the past 15 months. Longer maturity bonds had even greater losses. Bond investors are asking whether the 30-year history of rising bond prices and declining interest rates is at an end. Has the bond market been in a bubble and is that now popping?

While we are not inclined to making pronouncements about the "market," much preferring to discuss individual positions, we think these questions are legitimate, so we would like to outline the way we are currently addressing such questions in our internal, Investment Committee discussions.

We start with an acknowledgement that the economy is not in crisis, but it is not in great shape, either. Economic activity is limping along; job creation is anemic; inflation is subdued. The political system seems to excel in heart-stopping theatre, but little else. In addition, national debt has continued at nose bleed levels that introduce a mild panic when meditated on for too long, and private debt is also high. And what about the Federal Reserve?

The Federal Reserve's response (along with the responses of other agencies such as the IMF) indicates quiet alarm. The Fed admits to experimenting with a new monetary approach to increase liquidity. Their aim is to restore general confidence by creating a liquidity-driven lift in stock and housing markets. So far the results have been mixed. The stock markets have certainly gone up and housing prices seem to have recovered in part, but general confidence cannot be said to have been restored, yet. Confusion prevails as questions are being raised whether the Fed's actions have created a bubble in equities, or popped one in bonds. And worries persist about the impact, particularly on the bond and equity markets, if and when the Fed ends its experiments.

Here is where our approach and framework may be helpful to clients as we navigate the coming year. We are price-driven and market-agnostic in the purchase of assets. To take bonds, first, given the sluggish economy and low inflation, we expect low interest rates and high bond values to persist until economic growth returns.

Historically the U.S. economy has regained growth after sluggish periods. But currently, the overall U.S. debt levels (public and private) are constraining the return of high rates of "real" growth. By "real," we mean growth which is not simply inflationary. To get such growth, we must first pay down debt. That will take years, if it occurs at all.

Of course, rates could rise from sizable inflation. By "sizable," we mean one resulting from a commitment to increase liquidity similar in scale to the current efforts in Japan. Their liquidity efforts are nearly as large in absolute terms as those in the U.S. despite Japan having a much smaller economy. Such efforts would indeed be huge and hugely difficult politically. Until that tsunami of liquidity heads our way, we see bond investors experiencing a sideways market. The liquidity efforts of the Fed no doubt are helping keep bond prices up and interest rates down, but, even if they were withdrawn, we would not look for a sustained leap in interest rates or dramatic drop in bond values.

Equity investors face much the same muted conditions. In a consumer-led economy, the current constraining level of consumer debt limits corporate growth. For the past year, we have discussed in our Investment Committee how few companies were generating organic growth in the presence of rising stock prices. Instead, many companies simply paid out a higher percentage of their flat earnings in the form of a rising dividend. While more cash in the hand is appealing, it is only growing earnings that drive up a company's value.

We also saw other techniques to demonstrate “growth” in the face of flat or declining earnings. Some companies were aggressively repurchasing stock or making “bolt on” acquisitions. These are strategies which we like when appropriate. However, we did see a number of companies using sleight of hand accounting techniques. All these activities have been effective in causing many investors to move out of fixed income and return to stocks. It is part of the explanation, along with the liquidity injections by the Fed, for the good year stock prices enjoyed in 2013.

While such aggressive practices may cause some trimming as stock valuations rise more rapidly than their corporate valuations, we are comfortable that current prices do not indicate “bubble” conditions. As we review companies, the current prices are not extreme, but still reasonable, especially in light of the low interest rates. Further, the Fed’s efforts to lift the stock market have not shown euphoria in the form of many pension plans and individuals significantly increasing their allocation to stocks. In other words, the withdrawal of Fed support wouldn’t pop a “bubble”. Instead, such an event would just give us the opportunity to purchase more of the kinds of companies we have and are continuously seeking. At present such opportunities are somewhat less frequent, but they will still occur.

We hope this rather lengthy letter deepens your understanding of our process. We want you to stay informed and feel comfortable about our investing discipline. In communicating, we try to “do unto others as we would want done unto us.” If you’re new to Academy, past quarterly letters may be useful and may be obtained through your financial advisor or Margie Shelton at our office. In addition, our website (at www.academycapitalmgmt.com) has our investment reports on the individual holdings in your portfolio.

Government regulations also require us to send the enclosed copy of Academy's Privacy Notice and to make available a copy of our updated Form ADV - Part II (our regulatory filing with the SEC). If you would like one, please contact Robert Stovall at our office.

As always, we appreciate the stewardship responsibilities you entrust to us and your patience with our investment process.

Academy Capital Management